



UNITED STATES SENATE  
**REPUBLICAN  
POLICY COMMITTEE**

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*Democrats May Offer Amendment to Expand Faulty Tax Law*

## **Family Business Exclusion in Tax Code is Fatally Flawed**

Last week, the House passed a bill to make permanent last year's Death Tax repeal. Forty-one Democrats joined the House Republican majority to support the House bill. Today, Senate Republicans continue with their efforts to get permanent repeal adopted.

If Senate Democrats follow past practices, they will offer as an alternative to permanent repeal an increase in the current Qualified Family-Owned Business Interest exclusion from \$1.3 million to a higher level, perhaps to as much as \$4 million. They will argue that this substitute provides more targeted relief from the estate tax for small businesses and farms while preserving the tax for larger, non-business estates.

This approach, however, is badly flawed. Since its adoption in 1997, the Qualified Family-Owned Business Interest (QFOBI, or Section 2057 of the Internal Revenue Code) has provided little relief for family farms and businesses, and does not represent a viable approach to relieving the economic and social damage caused by the estate tax.

### **The Qualified Family Business Exclusion in Current Law**

Enacted as part of the 1997 Taxpayer Relief Act, QFOBI provides a total exclusion from estate taxes of \$1.3 million for qualified estates. To qualify, however, an estate must meet a series of stringent tests, including:

- The business must make up at least 50 percent of the estate's total value;
- Non-family heirs must have been actively employed by the family business for at least 10 years prior to the death of the owner;
- All heirs must continue to work for the business for five out of any eight years in the decade following the owner's death; and
- Business assets must be held by the family for any five years out of the eight years prior to the owner's death.

The tax benefits of the exclusion are subject to “recapture” if the heirs fail to meet the work requirements following the transfer of the business. These requirements, coupled with the recapture provision, make QFOBI extremely unattractive to families as they write their wills and plan for the dissolution of their businesses and estates.

## **The Democrats’ Alternative to Permanent Repeal of the Death Tax**

Past Democrat alternatives would raise the value of the QFOBI from the current \$1.3 million to \$4 million, supposedly excluding a large number of family-owned businesses that are currently subject to the Death Tax. It is likely the Democrat majority will use this approach again.

The Senate should defeat this effort. Expanding QFOBI would make worse everything that is bad about the Death Tax – it is extremely complicated, it plays upon uncertainty, it is expensive to pay for, and it destroys jobs.

### ***Timing in Life (and Death) Is Everything***

Perhaps the most critical flaw with Section 2057 is the question of timing. The Death Tax taxes uncertainty. No one knows when they will die and no one knows how much their estate is worth. This uncertainty adds to the cost and complexity of planning for the Death Tax. P.L. 107-16, the bill passed last year, addresses this flaw by replacing an excessive (55-percent) tax imposed on an unvalued set of assets at an unspecified time in the future with a more reasonable tax (20 percent on capital gains) imposed when the heirs sell the assets.

On the other hand, the Democrats’ proposal magnifies this flaw. In order to qualify for the exclusion, non-family heirs must be actively engaged in the family business for 10 years prior to the owner’s death. Meanwhile, the business itself must make up at least 50 percent of the total estate, and those assets must have been owned by the family for at least five out of eight years preceding the owner’s death. There’s a high degree of chance associated with all these conditions. Die too soon, and your estate fails to qualify for the long-term employee test. Die too late, and the value of your non-business assets may have appreciated too much, causing you to fail the 50-percent test.

### ***Another Job Destroyer***

The Death Tax also kills jobs. Business owners confronted by the tax and the estate planning it entails forego investing in their business and hiring new people [Douglas Holz-Eakin, “The Death Tax: Impact on Investment, Employment, and Entrepreneurs,” American Council for Capital Formation, August 1999]. What sort of dilemmas do the pre-death rules regarding QFOBI create for employers? There’s a rule requiring ownership of the business assets for five out of the preceding eight years prior to the owner’s death. Another requirement is the value of the business must exceed 50 percent of the total value of the estate. For a publically traded company with transparent stock prices, these tests may make sense. But what about a farmer who pays his taxes as a sole proprietor? Does the purchase or sale of a \$100,000 harvester endanger his ability to qualify for Section 2057? What about the large

crop he sold at the end of the year? All these questions have been raised in the legal community, all will affect the business practices of farmers and small business owners, and all could curtail their willingness to hire new employees.

### ***Democrats Create Spousal Penalty***

The typical American millionaire is married, and has been married for a long time [see, *The Millionaire Next Door*, by Thomas Stanley and William Danko]. Married taxpayers benefit under the death tax; both the husband and the wife can claim the unified credit when they pass on their estate. But the 50-percent ownership requirement under QFOBI may force couples to forego maximizing the value of the unified credit in order to maintain the correct business percentage. Given the uncertainty that surrounds the Death Tax under ordinary circumstances, the QFOBI adds exponentially to the cost and worry of estate planning. The Democrat approach of increasing the QFOBI exclusion exacerbates this problem.

### ***Democrats Preserve Generation-Skipping Taxes***

Elimination of the Death Tax would simplify the tax code immensely. Not only would it strike an entire subtitle and several hundred pages from the tax code, it also would abolish such tax-lawyer boons as generation-skipping taxes. This is where the government penalizes grandparents for giving directly to their grandchildren with tax rates that could exceed 70 percent. The Republican approach kills this vicious tax, whereas the Democrat amendment will preserve it.

This tax may affect family businesses. Suppose the owner has a grandchild take over the business rather than a son, daughter, or trusted employee. The grandchild qualifies under section 2057, but he also is subject to the generation-skipping tax and its excessive rates. The Democrat approach does nothing to address this unfairness.

### ***Democrats Restore Ten-Year Tax Cloud***

Another hurdle presented by Section 2057 is the tax cloud that hangs over a business following the death of the owner. The law requires that heirs must continue to work for the business for five out of any eight years in the decade following the owner's death. If they fail this requirement, the tax benefit from using the exclusion is recaptured, resulting in a hefty tax liability.

For 10 years, then, the IRS has a first-position lien on all the business or farm assets. Banks and other lenders are aware of this tax liability and curb their credit accordingly. Consider the plight of the heirs asked to run a business with limited credit opportunities. Section 2057 jeopardizes their ability to preserve and grow the family business.

## **Bar Association Voices Opposition**

For the above reasons and others, the QFOBI has attracted bipartisan opposition. Perhaps the most vocal opposition has come from the American Bar Association. A representative of the American Bar Association testified before the House Ways and Means Committee that the provision was too complicated to be effective:

The limited benefits provided by these Sections [2057 & 2032a], which is limited to a select group of taxpayers, should be contrasted with the substantial complexity they produce. In addition to their statutory and administrative complexity, the provisions encourage extensive tax planning and invite manipulation of ownership interests and asset use.

– Stefan B. Tucker, American Bar Association, May 25, 1999

## **Protect Family Farms and Business: Make Death Tax Repeal Permanent**

As a result of these myriad flaws, the Qualified Family-Owned Business Interest exclusion has failed to provide a reasonable level of protection for family-owned businesses and farms. According to the National Federation of Independent Business, “Qualifying for the family-owned business exclusion in current law is difficult, costly, and complex. Studies by numerous organizations and scholars routinely find that family businesses spend exorbitant amounts of revenues on lawyers, accountants, and financial planners.”

The United States Senate has voted twice to repeal the Death Tax, first, as a stand-alone bill in 2000, and second, as part of the Bush tax relief package enacted last year. Given the Senate’s position, the damage the death tax inflicts on communities and job creation, and the excessive complexity of the QFOBI, the Senate should take the obvious step and oppose Democrat efforts to save this tax. It’s time to end the death tax for good.

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